Switzer Super Report

Issue 341, 20 November 2014

Interest rate sense and sensibilities

The local market might be a bit depressed lately but that doesn't mean the savvy investor won't find value. Today Charlie Aitken gives his version of what's going on. He's more concerned by the falls in commodity prices than the 'housing bubble', which he says is just a sideshow and he upgrades, again, his view on Telstra.

Also in the *Switzer Super Report* today, we have a great *Fundie's Favourite* from Platypus Asset Management's Jelena Stevanovic on Ramsay Healthcare, Barrie Dunstan weighs into *The great income debate* and Roger Montgomery explains why it's hard to find alpha.

In *Buy, Sell, Hold – what the brokers say,* Pacific Brands gets an upgrade and a downgrade as iiNet also gets a downgrade, and in *Questions of the Week*, we answer queries about the global healthcare sector and regional banks.

Sincerely,

Peter Switzer

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Buy the US dollar and Telstra

by Charlie Aitken

Key points

- *The 'housing bubble' is a sideshow and the real concern is the pressure that lower commodity prices are placing on the budget and terms of trade.*
- *This means interest rates will be on hold for longer and the Aussie dollar will continue to come under pressure.*
- *Time to buy US dollar exposed assets, or the hard currency, and Telstra still has value.*

There were a series of events yesterday that pretty much encapsulated what is going on in Australia currently.

A day in review

The Medibank Private IPO range was lifted, due to strong demand, while the IPH IPO opened up a whopping 48%. This again reminds you that IPOs are a source of portfolio alpha in a broader Australian equity market that is range-bound.

The spot iron ore price fell to a five-year low, taking the entire Australian mining sector down with it. Oil prices continued to fall, while thermal coal and gold prices are also tracking at multi-year lows.

There was a guidance downgrade from Seven Group (SVW) due to weak capital equipment sales in Western Australia, which triggered a further de-rating of the listed mining services stocks.

Virgin Australia said *"domestic market competition is moderating"* and Qantas (QAN) shares rose to a fresh multi-year high.

By the end of the session the Aussie/US dollar had lost 1 US cent, the ASX200 had drifted down another 30 points to 5368, both unable to fight the macro sentiment pressure of falling commodity prices. On the other side, non-bank industrial yield stocks, US dollar industrial earners, and recent IPO's outperformed.

The speed and scale of the price falls in Australia's key commodity price exports means I need to reassess my interest rate outlook for Australia. These price falls in iron ore, coal, oil and gold are a very significant event for Australia's terms of trade, Federal Budget deficit, state government royalties, equity earnings growth outlook, inflation, unemployment rate and GDP growth.

What this all means is that the Federal Budget deficit hole is going to be much bigger than expected and Treasurer Hockey is going to have to cut spending even harder. Getting a few more bucks for Medibank won't offset the effect of collapsing commodity prices. That fiscal austerity, when combined with rising unemployment and weak wages growth, ensures the heavy lifting will have to be done by the RBA with monetary policy.

The more I sit here, the more I think 3yr government bond yields at 2.53% are sending us the right message about the medium-term interest rate outlook in Australia. In the medium-term I see no risk to the upside in Australian cash rates, and growing risks to the downside.

Low for longer

Forget the "housing bubble" arguments, they are a sideshow. The commodity prices we see today are a big issue for the Australian economy and will lead to an extended period of ultra-low or even lower cash rates.

This leads me to reinforcing my Australian equity strategy of being overweight US dollar earners and non-bank industrial yield stocks. It also leads to a positive disposition to domestic interest rate sensitivities such as discretionary retailers, building materials and infrastructure.

One thing I feel very certain of is the Australian dollar is about to have its legs chopped off (again). There is absolutely no way that with the action in commodity prices and changing views on the domestic interest rate outlook that the Aussie/US dollar cross will hold current prices. The Aussie/US dollar is poised for its next drop of 6 US cents and it could happen very quickly. I can't stress enough my strategy of physically getting some money into US dollars or buying US dollar earnings equities.

The ONLY thing recently holding the Aussie dollar up has been carry trade support from Japanese investors getting out of the depreciating yen. I have one piece of advice: sell to the Japanese.

Every gain we have made via shorting Aussie dollar this year (and last) has been shorting to carry traders who, to me, continue to overpay for the Australia's current, and I stress current, yield advantage to their home currency. The Australian Dollar is NOT a yield currency: it is a commodity currency and is in the process of becoming a commodity currency again.

I think near-term support around 85.60 will crack in the Aussie/US dollar cross and the next stop is 80 US cents. In all model portfolios I am short Aussie/US dollar as an overlay.

Stock weightings

Outside of bringing forward the timing of the next leg down in the Australian Dollar what other actions do my changing domestic interest rate views trigger?

Increasing weightings in non-bank industrial yield stocks where I see EPS and DPS growth over the next few years.

You can see the demand for Medibank and it's telling you something about what attributes investors are seeking.

However, the top 20 ASX stock with the greatest leverage to domestic interest rate expectations remains **Telstra (TLS).**

On the 15th of October I upgraded my Telstra recommendation back to buy at $5.29. At the end of that note I wrote:

Obviously most private domestic investors, the investors who dominate Telstra's register, are in it for the fully franked dividend. Those investors can look forward to another annual dividend lift this year. To me that means how Telstra's share price performs comes simply down to what price domestic SMSF's will pay for Telstra's likely 31 cent fully franked dividend in FY15. Clearly that will be driven by sentiment towards global and local cash rates.

6.00% yield = $5.16

5.50% yield = $5.63

5.00% yield = $6.20

I suspect given flat domestic cash rates, volatile equity markets and volatile bond markets, that Telstra prospective dividend yield will settle in the 6.00% fully franked to 5.50% fully franked band over the year ahead. With the stock at the bottom end of that prospective yield trading range (5.86%/8.37% grossed up @$5.29) I am upgrading it to buy today, expecting a 12 month total return of 10% to 14% including the value of franking credits.

I actually wasn't bullish enough in that Telstra upgrade but anyone who followed it has still made 8.6% in a month.

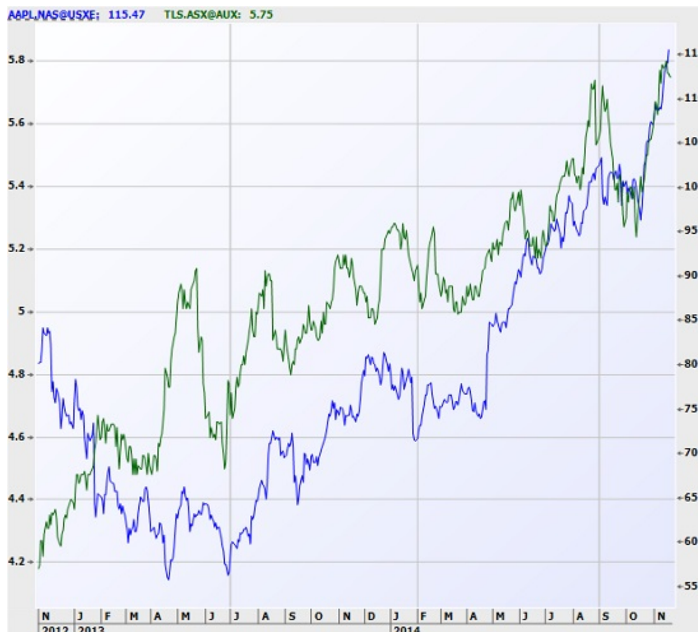
Telstra upgrade

Today, given my changing views on domestic interest rates, I am going to UPGRADE my Telstra target trading range to 5.50% to 5.00%. That equates to a $5.63 to $6.20 share price range, based off a 31 cent fully franked FY15 dividend forecasts.

Telstra recently hosted an analyst day, which gave me even greater confidence in their earnings outlook. That in turn gives me greater confidence in their dividend outlook.

Similarly, Apple's hugely successful iPhone sales are a positive for Telstra in terms of increased mobile data usage. Interestingly, Apple and Telstra shares have a strong correlation (below) which actually makes fundamental sense.

Apple leads Telstra



Telstra's "lost decade" has ended and we are moving into a new higher trading range. Again, this fundamentally makes sense.

Once you have shorted more Australian dollars go and buy a few more Telstra. I think the yield will get bid down to 5.00%ff on FY15, which equates to a $6.20 price target. At $6.20, on 18.6x, they'd still be on a P/E discount to Medibank.

Go Australia, Charlie

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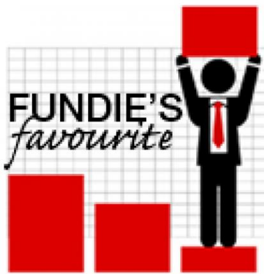


Ramsay – still a great addition to a portfolio

by Fundie's Favourite

Key points

- *Private hospital operator Ramsay dominates domestic markets and is growing internationally, particularly in Europe.*
- *By delivering NHS work more efficiently in the UK, Ramsay has become a preferred provider.*
- *Platypus has a sell price of above $60 which means there's still growth in the stock if you buy today.*

How long have you held Ramsay Healthcare?

We have held Ramsay Health Care (RMC) since November 2010 and our current weighting is 4.5%.

What do you like about it?

Ramsay is a leading private hospital operator in Australia, with impressive offshore divisions as well. The company has consistently delivered growth for over a decade, outperforming both in Australia and in tough offshore markets such as the UK.

In addition to being a market leader in the domestic market, Ramsay has significant growth potential in new geographies. The company has recently substantially grown its business in France and, through its joint venture with Sime Darby, intends to expand its operations into new markets across Asia.

The pressures on public healthcare spending in geographies where Ramsay operates, together with ageing populations, will continue to drive demand for private health services such as Ramsay's. Therefore, this business is well positioned to continue to deliver growth through greenfield and brownfield expansion opportunities, as well as through acquisitions.

How is it better than its competitors?

Ramsay is a clear market leader in the Australian market, demonstrated not only through its size and quality of its assets, but also its high operating margin.

Ramsay has consistently delivered margin improvements in Australia through running a number of initiatives such as directly sourcing consumables, reducing exposure to agency nursing staff, and continuing to improve its facilities through successful brownfield expansion strategy. Ramsay has led in each one of its strategies and as such its operating margin is higher than that of its competitors.

In addition, Ramsay has managed to maintain its margin in the very tough UK market. It has been successful in delivering NHS (National Health Service) outsourced work in a more efficient manner and did not suffer from a downturn in private patient volumes during tough economic times. Ramsay is now a preferred NHS provider, while some of its competitors are now just starting to explore that strategy.

What do you like about its management?

Ramsay's management has demonstrated it can deliver growth above its competitors through a number of initiatives that are ahead of its peers. Namely, Ramsay has run a successful brownfield expansion strategy for a number of years while Healthscope, its closest competitor in the Australian market, is just starting to explore that opportunity.

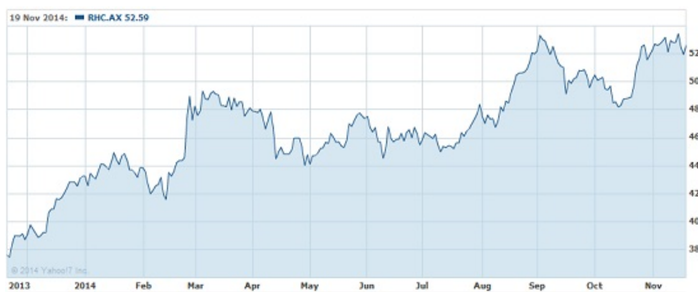
Similarly, in the UK, Ramsay's management positioned the company to benefit from a large volume of NHS outsourced work. This work is lower price than private, elective work; however, the demand growth is more stable and as such Ramsay did not suffer from a reduced volume growth like a number of its competitors that operate in purely private segment. Ramsay management has demonstrated that Ramsay is a very efficient operator as it has been able to deliver steady, reasonably strong margin even when relying on lower price NHS work.

In addition, Ramsay's management has run a very successful cost out strategy, such as starting to directly source its consumables, reducing the number of suppliers and negotiating better supplier terms, reducing its agency staff costs, etc. Therefore, Ramsay has been able to deliver leading returns for a number of years.

What is your target price on Ramsay?

Our price target for Ramsay is in low to mid $60s.

Ramsay Health Care Limited (RHC)



Source: *Yahoo!7 Finance, 20 November 2014*

At what point would you sell it?

Ramsay is one of best quality growth stocks with defensive characteristics as well. The company is in a unique position as a growing reliance on the private sector to deliver health services, combined with an ageing population, will continue to deliver strong demand growth for Ramsay services for a number of years. We would only sell Ramsay if some external factor, such as government policy change, resulted in a reduced demand outlook.

How much has it added to your overall portfolio over the last 12 months?

In the last 12 months Ramsay has added 18 basis points to our portfolio.

Is it a liquid stock?

Yes, but Paul Ramsay Family Trust still holds 34%.

Where do you see the value?

We believe that Ramsay will continue to deliver value through its brownfield expansion opportunities, greenfields as well as public private partnerships. Developed countries are all facing growing budget pressures, in particular from healthcare spend that is forecast to grow above economy growth projections. Therefore, we believe there will be more initiatives such as NHS outsourcing to private sectors across geographies where Ramsay operates. Ramsay, as a market leader and most efficient operator in most of its geographies, is in an excellent position to benefit from this growth in demand.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

Broker actions have been heavily weighted towards downgrades so far this week, following AGMs and divestment announcements.

JP Morgan upgraded Pacific Brands (PBG) to Neutral from Underweight. The company will divest its Brand Collective division for $39 million to various parties. JP Morgan believes this will remove a distraction for management and simplify the business. The broker considers the recent revenue growth is a positive development but is concerned the business is repositioning at a time when gross margins are under pressure from the currency. (see downgrade below)

In the not-so-good books

Credit Suisse downgraded iiNet (IIN) to Neutral from Outperform following the AGM, which revealed continued subscriber growth but also increasing costs. Credit Suisse is downgrading earnings forecasts by 5% following the strong performance of the stock over the year to date. The broker continues to expect the small cap telco sector will benefit from industry consolidation and this should underpin iiNet.

Macquarie downgraded Orica (ORI) to Underperform from Neutral. The headline FY14 result was just ahead of Macquarie's forecasts but the quality was considered low, boosted by asset sales and a 23% tax rate. The broker is underwhelmed by the value of the chemicals division sale but considers the capital management potential good news, although any buy-back will not be announced until around March next year.

Citi downgraded Pacific Brands to Neutral from Buy. The company has sold Brand Collective for what Citi considers is a very low $39 million. The broker lowers earnings forecasts by 5% for FY15 and by 6% for FY16, given the net loss of earnings from the sale. Citi observes restructuring is now mostly complete and the remaining brands have far greater equity but downgrades because of the recent share price moves. A 55c target is retained. See upgrade.

Morgan Stanley downgraded Toll Holdings (TOL) to Underweight from Equal-Weight. Morgan Stanley suspects management's return-on-capital targets are challenged. Only the network businesses offer the leverage, namely forwarding and express, and these two also have their challenges.

The above was compiled from reports on FNArena, which tabulates the views of eight major Australian and international stock brokers: BA-Merrill Lynch, CIMB, Citi, Credit Suisse, Deutsche Bank, JP Morgan, Macquarie and UBS.

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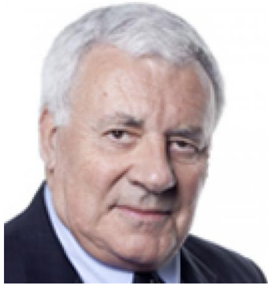

The great income debate

by Barrie Dunstan

Key points

- *More and more people are starting to talk about, and offer a variety of options for, maintaining retirement incomes.*
- *There are plenty of products available to manage this risk but retirees need to understand the pros and benefits of each kind of approach.*
- *In a low interest rate environment, a reverse mortgage could offer one alternative for maintaining income.*

It may have taken a visiting Nobel laureate Robert Merton to get debate about the superannuation system onto a more sensible track. He recently underlined the need to focus on potential retirement income rather than accumulated lump sums.

But it's not clear that we needed the US professor from MIT to get the ball rolling, because it's already happening: underlying figures from SuperRatings show that more than 25% of super fund assets are in pension-paying funds (especially in retail master trusts and self managed funds).

Something different

Merton's suggested retirement income centred not on the usual diversified portfolio used by most Australians, but on his own recipe of a mixture of annuities and deferred annuities, government bonds and reverse mortgages.

However, the annuity market here is still under-developed and government bonds are scarce and low-return. We are waiting on David Murray's committee to report on retirement income policy, and moves to make funds report members' potential retirement income rather than just their lump sum.

Funds have been lagging in projections of retirement income and it would require a ruling from government to make sure this was done uniformly. And nothing can disguise the fact that most current projections would produce disappointing results if it were not for the age pension safety net.

But awareness about pensions is rising and major annuity provider Challenger has just released a detailed paper on how best to approach income streams.

The paper, written by Challenger's chairman of retirement income, Jeremy Cooper, and Wade Pfau, professor of retirement income at Byn Mawr, Pennsylvania, usefully points out that there are two different philosophies to retirement income planning: probability-based and safety-first.

The probability approach relies on simulations of investment returns to identify a portfolio with, say, a 90% chance of success; the safety first school would focus on that 10% chance of failure. The first approach uses modern portfolio theory (such as diversification) and relies on long-term returns to produce income. It can be brought undone by the timing of bad investment markets.

The second approach tries to match assets to goals to control risks and uses tools like annuities.

The paper says no one approach is wrong or right; funds and advisers need to offer retirees the approach that best suits them. It discusses alternatives at great length, ranging from safe withdrawal rates (the so-called 4% a year rule) and using "buckets" like cash, fixed interest and stocks. The ultimate is a safety first income based on an

inflation-linked, immediate annuity (which, of course, depends on final savings and interest rates at retirement).

A low return rate environment

What Robert Merton's work and the Challenger discussion paper emphasise, is that investment habits and markets in Australia make it difficult to construct retirement income projections – let alone deliver the income. The most pressing issue is low interest rates, which directly influence potential returns, especially on annuities. (Challenger annuities, with full indexation for inflation, are offering a male at 65 only 3.86% return on their capital.)

Low interest rates (and potentially lower equity market returns) also feed into account-based pensions. Over the past 10 years, rolling returns on balanced funds have run at just under 7%pa based on SuperRatings numbers. Sure, some shorter terms look better – 11%pa over three years and 8.3%pa over five years – but volatility isn't far away, with the seven year number of 4%pa including the GFC period.

But the unspoken problem is that many Australians prefer saving outside super by investing in the capital gains tax-free family home and, increasingly, negatively-geared investment property. These are fine for accumulating wealth but awkward to unlock regular income (and may over-weight property assets).

Robert Merton and others suggest accessing these savings via reverse mortgages, which aren't popular or widespread. Changing this would require a radical re-think – both by savers and the government, because tax incentives available for decades have distorted people's personal investment habits.

Now, if future returns – and retirement incomes – are starting to look skinny or uncertain, and governments limit the absolute savings which can go into superannuation, pushing people into reverse mortgages for retirement income might look like a pragmatic (if unlikely) solution.

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The eternal chase for alpha

by Roger Montgomery

Key points

- *For corporate earnings to grow, the companies you invest in need to make good on their expansion plans.*
- *It helps to be fully invested. A portfolio with a large chunk allocated to cash is rarely going to outperform the index.*
- *Finding alpha needs access to a wide universe of stocks, and some detailed research.*

We all know alpha, that elusive figure of outperformance that sustains the industry of investment management (of which yours truly is a part of). We all wish to own portfolios with positive alpha, such that our wealth will grow to new heights on the back of long-term compounding returns. However, alpha is notoriously difficult to acquire and with some slight of thought it's quite easy to answer the question of why this is so.

In a nutshell, alpha is calculated by subtracting the annual return of a stock index (such as the ASX 300) from the annual return of your stock portfolio.

A sum of two parts

We can break stock returns down into two basic parts, corporate returns, e.g. higher stock prices, which are driven by increasing earnings, and random returns. The index is basically just another portfolio of stocks with returns that comprise both a corporate part and a random part.

For the earnings (and hence corporate value of the firm) to grow at a good clip going forward we need to see high returns on the expansionary plans the stocks in our portfolio decide to take up. The same can be said for the group of firms in the stock index. From this, we can see more tangibly that to earn positive alpha, we need the firms in our stock portfolio to grow their earnings at a higher rate than that of the stock index portfolio.

Of course we don't want just want one or two years of outperformance before we call it a day, we'd really prefer say 10, 20 or more years of (averaged out) outperformance to build our wealth significantly. We require some sort of mechanism for each firm in our portfolio that will protect the growth of their earnings over the long haul from competition, i.e. a competitive advantage.

If we have a portfolio of, say $100,000 with only $10,000 allocated to stocks with the remainder in cash, we're going to have a pretty tough time outperforming the stock index. For example, if our stocks achieve an excellent 30% return and our cash earns 3% in interest, the combined portfolio return is 5.1%. The stock index only needs to achieve 5.2% for our alpha to be negative in this case (and note, the long-term averaged return of the ASX 300 accumulation index is 10-11% per annum). Hence alpha generation requires that we have a sufficient weighting to stocks in our portfolio such that the growth in earnings will still produce a positive alpha.

Price point

Finally we need to consider the price level at which we are holding our shares. This point is slightly more complicated, but we can summarise by saying that if a share is trading significantly above its intrinsic value, its growth going forward is unlikely to be spectacular. For example, if we hold a stock that's trading at $2 when our analysis determines it is worth $1 this year, $1.10 next year and $1.21 the year after due to growth in earnings. We can see that we'll

likely have a long wait before value catches up with price. In the interim, there's little in the way of a case to expect the high returns to continue.

So we now have a few tools, which can help us to gauge the propensity for our portfolio to generate positive alpha. Reverting to our original question of why it's generally difficult to outperform the stock index, consider that the index is made up of some of the largest companies in Australia and whilst they're not all perfect, generally they are profitable and can grow their earnings at a fairly good clip over the long haul. The index is also 100% invested at all times, leveraging its performance to the benefits of long-term growth in earnings to the utmost.

To beat this index, the investor is challenged to find a firm to invest in that can both grow its earnings for an extended period of time at a high rate and be available for purchase at a suitable price level. The investor must also find several of these companies so as to not be under diversified or hold too much cash, the former presenting a concentration of risk and the latter would almost certainly lead to negative alpha over the long haul.

Positive alpha is difficult to achieve as noted, yet through detailed research and a wide enough basket of potential stocks to research it is very possible.

Mind you, if it were easy, there would be no alpha to catch.

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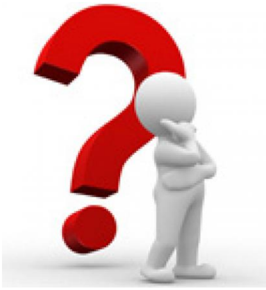

Regional banks and healthcare

by Questions of the Week

Question: I watched the interview with Rudi Filapek-Vandyck by Peter during the week and he spoke about the healthcare sector in Australia. I am looking at ETFs like IXJ for overseas exposure to the sector. What is your view? Is it going to grow like the Australian patch?

Answer (By Paul Rickard): If there is one industry I would be inclined to back and invest globally in, that is healthcare.

One of the easiest ways to do it is through iShares Global Healthcare ETF, ASX code IXJ.

One caveat – the stocks that make up the index are trading on a multiple of a touch under 29 – so it is arguably pretty pricey.

Maybe it is something to buy during market weakness.

Question 2: What about the next tier of banks, like AMP or BOQ, etc. Are they likely to see more serious growth as the demand for lending increases with the economy picking up?

Answer 2 (By Paul Rickard): I am in the camp that the minor/regional banks have already had their run. If you look at the performance over the last two years, you will see that most of the regional banks have outperformed the major banks (Commonwealth Bank largely excepted).

Going forward, I don't quite see the evidence for continued outperformance. They could be winners from the Murray Inquiry (question whether some of this may be already priced in) – my sense is that their biggest risk will be lack of investment in technology.

So, I am not inclined to make the switch into the regionals.

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